MEMORANDUM OF LAW

DATE: March 25, 1991

TO: D. Cruz Gonzalez, Risk Management Director
FROM: City Attorney
SUBJECT: Flexible Spending Accounts

QUESTION PRESENTED

You have asked this office for an opinion concerning the City's plans for implementing Flexible Spending Accounts (FSAs) through payroll deduction in conjunction with the City's cafeteria plans effective July 1, 1991, comply with Section 125 of the Internal Revenue Code (IRC) as it pertains to the tax treatment of FSAs.

Pursuant to this request, you attached a memorandum to you dated October 1, 1990, from Larry Weckman, Auditor and Comptroller Department concerning FSAs. This memorandum posed the following five questions:

1. Is ┌sicσ the total gross wages (prior to reduction) or the net wages (after reduction) subject to Medicare?

2. What amount should retirement contributions be based on? The gross biweekly salary? The biweekly salary net of salary reduction?

3. How are SPSP contributions to be computed? Net of FSAs (as in Deferred Compensation)? Or are they to be treated as in 401(k)?

4. What priority would these accounts have in our deduction priority? An attachment dated October 1, 1990, to Joe L. Lozano, Assistant Auditor and Comptroller from Larry Weckman, Financial Systems Division Manager setting forth the City's payroll deduction priority sequence was attached.

5. Is the amount withheld for salary reduction reportable on the employee's W-2? Separately for each plan? If so, is the

amount to be reported the amount withheld or the amount actually paid?

In addition, you attached correspondence dated October 5, 1990, to Valerie VanDeweghe, Flexible Benefits Administrator, Risk Management Department from Sheldon R. Emmer, Principal, A. Foster Higgins & Co., Inc., concerning their responses to the questions posed in the above described memorandum from Larry Weckman to you. Finally, you submitted a copy of your memorandum dated December 4, 1990 to Larry Weckman, Financial Systems Division Manager responding to the questions posed by him in his

October 1, 1990, memorandum concerning FSAs.

In your December 4, 1990 memorandum, you offered the following responses:

1. Net wages (after reduction) are subject to Medicare.
2. Retirement contributions are based on the gross bi-weekly salary.
3. SPSP contributions will be based on the gross bi-weekly salary as in 401(k).
4. FSAs should be third in priority after 401(k) and before Federal Income Tax (FIT).
5. The health care FSA salary reductions are not shown on the W-2. Dependent care FSA reimbursements are shown on the W-2. The City can show either the actual reimbursements or the salary reduction amount according to Internal Revenue Service (IRS) pronouncements. Since the Auditor's office currently reflects the actual reimbursement, it seems prudent to continue this procedure.

BACKGROUND

The City wishes to offer FSAs through payroll deduction in conjunction with its cafeteria plans effective July 1, 1991. The implementation of this benefit will impact various system operations. Concerns about the wages subject to Medicare, the wages that retirement or SPSP contributions will be based on, the priority of an FSA deduction in the City's payroll deduction priority sequence and the reporting requirements for health care or dependent care FSA deductions have arisen.

The City's consultant on benefit issues, A. Foster Higgins & Co. Inc., has provided responses to the concerns raised. In addition, The Wyatt Company and Buck Consultants, other City consultants on benefit issues, have provided their assessments of the issues presented and the responses suggested. Finally, independent counsel, Robert A. Blum, a tax specialist with the firm Orrick, Herrington and Sutcliffe located in San Francisco has provided assistance in answering the questions posed by the Larry Weckman memorandum dated October 1, 1990.

This memorandum is in response to your questions concerning the City's plans for implementing FSAs, as outlined in the five responses contained in the December 4, 1990 memorandum, comply with Section 125 of the IRC as it pertains to the tax treatment of FSAs. With the exception of the proposed response to question three concerning the wage base to be used for the calculation of contributions to the SPSP/SPSP-M Plans and question four concerning the location of the deduction for a FSA in the City's payroll deduction priority sequence, we concur with your

responses. With respect to question three, however, we advise that the wage base to be used for the calculation of SPSP/SPSP-M contributions should exclude those amounts allocated to either section 457 deferred compensation or section 125 FSAs. With respect to question four, we advise that the FSA deduction should be second in the City's payroll deduction priority sequence. Our analysis follows:

ANALYSIS

1. Net wages are subject to Medicare.

Medicare is found under the Federal Insurance Contributions Act (FICA), 26 U.S.C. section 3101 et seq. of the IRC. Under FICA, the term "wages" does not include "any payment made to, or on behalf of, an employee or his beneficiary - under a cafeteria plan (within the meaning of Section 125) . . . ." Section 3121(a)(5)(G) of the IRC. As such, net wages (after reduction for the health FSA) would be subject to Medicare.

In response to related questions concerning other wages subject to FICA, we note that "any employer contribution under a qualified cash or deferred arrangement (as defined in section 401(k) to the extent not included in gross income by reason of Section 402(a)(8)" is subject to FICA pursuant to IRC section 3121(v)(1)(A). In addition, "any amount treated as an employer contribution under section 414(h)(2) where the pickup referred to in such section is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise)" is subject to FICA pursuant to IRC section 3121(v)(1)(B). Finally, deferred compensation under Section 457 is also subject to FICA under IRC section 3121(v)(3)(A).

2. Retirement contributions should be based on the gross bi-weekly salary.

Currently, contributions to CERS are based on an employee's gross bi-weekly salary. Contributions to the City's unqualified deferred compensation plan under IRC section 457 are not subtracted from the employees gross wages before the CERS contribution is calculated. In our opinion, salary deferrals under FSAs pursuant to IRC section 125 should be treated in the same fashion. They should not be subtracted from an employee's gross wages before calculating the CERS contribution.

Initially, we note that any change to the definition of compensation which would alter the current wage base for assessing CERS contributions would constitute a change of benefits resulting in a potential violation of the contract clauses of the State and Federal Constitutions. U.S. Const., art. I, section 10, cl. 1; Cal. Const., art. I, section 9. The

removal of contributions to the section 457 plan or the exclusion of section 125 FSAs from the wage base used to calculate CERS contributions could result in a substantial change in benefits, keeping in mind that CERS is a defined benefit plan.

CERS authorizes benefits to be calculated on the highest one year of base compensation. Potential problems of underfunding could arise if the CERS definition of compensation were revised to exclude allocations to deferred compensation or the proposed FSAs. For example, the employee uses sections 457 and 125 to their fullest until the year before retirement. If, at that time, participation in these plans is dropped, the final year of compensation used for the calculation of the CERS benefit would be substantially higher than previous years. Thus, the benefit received would exceed the benefit projected based on the previous retirement contributions, resulting in a potentially underfunded system.

This potential problem disappears if the CERS contributions continue to be based on an employee's gross bi-weekly wages regardless of whether or not the employee chooses to participate in either a section 457 deferred compensation plan or the proposed section 125 FSAs. In light of the foregoing, it is our recommendation that the City continue to use a wage base consisting of an employee's gross bi-weekly wages for calculating CERS contributions regardless of whether the employee participates in either a section 457 or a section 125 FSA.

3. SPSP contributions should be based on the net bi-weekly salary after reduction for the FSA.

SPSP/SPSP-M are defined contribution plans. Prior to 1990 the City calculated contributions to SPSP/SPSP-M on an employee's gross bi-weekly wages which included any contributions to section 457 deferred compensation. In a Memorandum of Law dated April 19, 1989, this office confirmed The Wyatt Company's conclusion that, for the IRS nondiscrimination rules, IRC section 414(s) prevented monies contributed by a City employee to a section 457 deferred compensation account from being treated as compensation for the purpose of calculating benefits under the SPSP/SPSP-M Plans. That advice was based on an amendment to IRC section 414 which changed the definition of compensation for pension plan tax qualification purposes. Pursuant to these changes, the City began excluding section 457 deferrals from the wage base for calculating contributions to the SPSP/SPSP-M Plans.

On May 14, 1990, the IRS issued temporary regulations relating to the scope and meaning of the term "compensation" as

used in IRC section 414(s) which permitted the inclusion of section 457 deferrals in the definition of compensation. Proposed Regulation section 1.414(s)-1T(c)(4)(ii). Notwithstanding this change, the City has continued to exclude section 457 deferrals from the wage basis for the purpose of calculating contributions to SPSP/SPSP-M Plans.

Section 125 FSAs raise similar concerns. Section 414(s) subdivision (3) provides that an: "Employer may elect to treat certain deferrals as compensation. An employer may elect to include as compensation any amount which is contributed by the employee pursuant to a salary reduction agreement under section 125, 402(a)(8), 102(h) and 403(b)."

Clearly, just as in IRC section 457, the law allows the section 125 FSAs to be included in compensation. The question becomes, does the City want them to be included in a definition of compensation? Pursuant to the advice from all of the City's consultants on benefits issues, The Wyatt Company, A. Foster Higgins & Co., Inc., and The Buck Company, this office and independent counsel, the City has decided that, for the purpose of calculating contributions to the SPSP/SPSP-M plans, allocations to section 125 FSAs will be treated the same as IRC section 457 deferrals. They will be excluded from the wage base.

Support for this position is found in the IRC, the SPSP/SPSP-M Plan documents and in policy decisions designed to prevent future violations of the benefit limits set forth in IRC section 415 (section 415). Subdivision four (4) of proposed regulation section 1.414(s)-1T provides that:

> Any definition of compensation provided in paragraph (c)(2) ┌compensation within the meaning of IRC section 415(c)(3)σ or (c)(3) ┌the safe harbor alternative definition of compensationσ of this section will satisfy IRC section 414(s) even though it is modified to include all of the following types of elective contributions and all of the following types of deferred compensation. (Emphasis added.)

Elective contributions under sections 125, 402(a)(8), 402(h) and 403(b), compensation deferred under section 457(b) and employee contributions described in IRC section 414(h)(2) that are picked up by the employer are specifically mentioned. As such, inclusion or exclusion of any one of the above described

items in compensation requires that the remaining items be treated in a like manner. It is an all or none proposition. Thus, exclusion of section 457 deferrals, if it continues, requires exclusion of the proposed section 125 FSAs.

Policy decisions designed to prevent future violations of section 415 support the exclusion of section 457 deferrals and section 125 FSAs from the definition of compensation for the purpose of calculating contributions to the SPSP/SPSP-M Plans. The richness of the SPSP/SPSP-M Plans coupled with the very real probability that section 415 could be violated when participants utilize sections 457 or 125 to their fullest warrants the exclusion of these items from the wage base for calculating contributions to the Plans. Thus, even though the Plans contain specific sections covering the priority of reductions in employee and employer contributions to achieve compliance with the limitations set forth in IRC section 415, there is an extraordinary administrative cost and burden in utilizing these corrective provisions. In addition, the psychological effect of reducing benefits in this manner could be devastating resulting in serious employee relations problems. All of these problems can be avoided by limiting the contributions going into the Plans. Since IRC section 415 uses only W-2 income for testing purposes, exclusion of the voluntary section 457 deferrals and section 125 FSAs minimize the chances that any violations of section 415 will occur.

In addition, the fact that different definitions of compensation are used for the calculation of contributions to

CERS and SPSP/SPSP-M does not violate the IRC. Proposed regulation section 1.414(s)-1T(b) provides that:

> ┌Aσny definition of compensation that satisfies section 414(s) may be used to determine whether a particular money purchase pension plan satisfies section 401(a)(4). At the same time, a different definition of compensation that satisfies section 414(s) may be used to determine whether a defined benefit plan maintained by the same employer and not aggregated with the money purchase plan satisfies the requirements of section 401(a)(4).

Finally, section 14.01 of the SPSP/SPSP-M Plans indicate that the Plans are purely voluntary on the part of the employer.

Section 11.01 of the Plans further provides that the employer shall have the right to amend the Plans at anytime to comply with federal or state laws. In light of the foregoing, any proposed changes to the Plans including the recent exclusion of section 457 deferrals and the proposed exclusion of section 125 FSAs from the wage base for the purpose of calculating contributions to the Plans do not violate the contract provisions of either the State or Federal Constitutions. The plan documents themselves provide for and contemplate future changes in benefits.

4. FSAs should be second in the City's Payroll Deduction Priority Sequence.

FSA salary reductions under section 125 have no particular priority per se in a payroll sense from a tax standpoint. They are not subject to state or federal income tax, FICA, FUTA, or state disability tax in California. As such, they would reduce the gross before those taxes are taken. In addition, although contributions to CERS will be calculated on an employee's gross bi-weekly wages, the same is not true for the calculation of contributions to SPSP/SPSP-M. For SPSP/SPSP-M the contributions will be calculated on the net bi-weekly salary after a reduction for section 125 FSAs and section 457 deferred compensation. Since FSAs will be treated in the same manner as deferred compensation we recommend that the FSA deduction should be second in priority after the deduction for deferred compensation.

5. Health care FSA salary reductions are not shown on the W-2.

   Dependent care FSA reimbursements are shown on the W-2. The City's current practice of reflecting the actual reimbursement is permissible.

Health care FSAs are not shown on the W-2 because they are treated like any other medical plans provided by an employer. As such, they are excluded from an employee's gross income for tax purposes. Dependent care FSAs, on the other hand, are not medical plans. Consequently, they are included on an employee's W-2 form. According to the Internal Revenue Service, an employer may show either the actual reimbursements or the salary reduction amount. Clearly, the City's current practice of reflecting the actual reimbursement is permissible. Since the City currently reflects the actual reimbursement, you have suggested that prudence dictates continuance of this procedure.

You have also indicated, however, problems encountered by the City over the receipt of reimbursement requests which fall outside of the fiscal year deadlines for processing these

requests. Many of these requests are unintentional and unavoidable. If this has posed serious or administrative problems, you may wish to reevaluate the City's current practice of reflecting actual reimbursements on the W-2. A change to reflecting the salary reduction amount may prove to be more efficient from an administrative standpoint.

CONCLUSION

In summary, it is our opinion that net wages after reduction for the FSA are subject to Medicare. Retirement contributions should be based on an employee's gross bi-weekly wages. SPSP/SPSP-M contributions should be based on the net bi-weekly salary after reduction for the FSA. The FSA deduction should be second in priority in the City's payroll deduction priority sequence. Finally, health care FSAs are not shown on the W-2. Dependent care FSAs are shown on the W-2. Although the City's current practice of reflecting the actual reimbursement is permissible, the City may wish to change this procedure and reflect the salary reduction amount to avoid administrative problems in processing reimbursement requests.

JOHN W. WITT, City Attorney
By
Loraine L. Etherington
Deputy City Attorney

LLE:mrh:352.3(x043.2)
ML-91-24